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SUBJECT: BANK OF ESTONIA: GDP SLUMP IN '09, RECOVERY IN 2010...EURO IN 2011?

REF: A) TALLINN 355
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¶1. (SBU) SUMMARY: The Bank of Estonia's (BOE) most recent economic forecast calls for 15 more months of negative GDP, with economic recovery coming in 2010. The Bank identified three reforms it hopes the Government of Estonia (GOE) will prioritize during the downturn: Euro accession, fiscal sustainability, and structural reforms to enhance competitiveness. The BOE sees the Nordic banks that operate in Estonia as being stable enough to cope with both the current global crisis and the Estonian economic downturn. Private-sector analysts second the notion that Estonia's case is more stable than other troubled EU economies. The country's previously high current account deficit - a major concern in recent years - is falling, and major credit rating agencies continue to give Estonia solid marks. END SUMMARY.

GDP Sagging Until Late 2009, Recovering in 2010
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¶2. (U) The BOE recently released its autumn forecast for the rest of 2008 through 2010. The Bank predicts Estonia will experience GDP growth of minus 1.8 percent for this year, deepening to minus 2.1 percent in 2009. The Bank expects recovery to begin in late 2009, leading back to positive growth of 3 percent overall for 2010. The report points out that the current economic correction has been more abrupt than expected primarily due to decreasing domestic demand. The forecast recognizes that growth predictions for Estonia not only depend on domestic factors but also on the assumption that global markets will stabilize in 2009. A turnaround in Estonia's economy is directly linked to "the country's success in utilizing and expanding its export potential."

Central Bank to GOE: Keep Your Eye On the Ball

¶3. (U) BOE Deputy Governor Andres Sutt commented to visiting EUR DAS Judy Garber on October 30 that "every downturn presents an opportunity for reform." He noted three specific areas where the Bank hopes the Government of Estonia (GOE) will focus its attention. The first is adoption of the Euro by 2011. With falling oil and food prices, and falling consumer demand expected to bring down inflation, Estonia "has a once in a lifetime opportunity" to get into the Eurozone, Sutt said. According to BOE's forecast, Estonian

inflation will drop to 4.8 percent in 2009, and be close to the Maastricht inflation criteria at the end of 2010. (NOTE: Under Maastricht, inflation can be no more than 1.5 percentage points above the average of the three lowest inflation rates among EU member states. For the past several years, Estonia's above average inflation rate has been the single factor keeping Estonia from eligibility for Euro zone accession. END NOTE)

¶4. (U) According to the BOE, the second key priority for the GOE during this downturn should be long-term fiscal sustainability. Sutt made it clear that he also believes the GOE has the discipline to control the state budget, and defer major investments if necessary, even though it also faces falling tax revenues and pressure to stimulate the economy with state spending. According to the Bank's estimate, the consolidated state budget for 2008 and 2009 will be in deficit, but thanks to reserves accumulated in previous years, public sector debt will grow only minimally. (NOTE: At present, the 2009 state budget is balanced, on paper - but it has not been approved by Parliament, and experts believe projected revenues will fall short next year. END NOTE) The BOE's forecast accepts that a "temporary and moderate" budget deficit is acceptable under the current circumstances, and would not pose a risk to economic stability or euro adoption as soon as possible.

¶5. (U) Finally, Sutt highlighted the need for the GOE to undertake structural reforms to enhance Estonia's

competitiveness. The Bank's forecast emphasizes the importance of continuing efforts to maintain and improve a business environment supportive of investment, including increasing the flexibility of the labor market. Both the OECD and the World Bank have highlighted the need for increased labor market flexibility to promote long term economic growth. The Ministry of Social Affairs has drafted a new labor law which seeks to address this issue. The legislation is currently under review by the Parliament.

Markets Stabilizing?

¶6. (SBU) Private sector analysts stop short of saying that the worst is over, but suggest Estonia may be nearing the bottom of its economic downturn. Mihkel Viks, a market analyst at Estonia's largest bank, Swedbank, told us he believes large international investment funds had already started to pull money out of Estonia more than year ago because they feared a macroeconomic slowdown. Tallinn's stock market, the OMXT, peaked in the beginning of February 2007 and has lost a staggering 70 percent of its value since then. According to Viks, the sell-off here started a few months earlier than other markets, and most nervous investors already left some time ago.

¶7. (U) Tanel Ross, Head of International Relations for the Bank of Estonia stated recently that Estonia's situation is not like that of Iceland, Hungary or Ukraine, and the Bank does not see any likely scenario in which Estonia would need to apply for a loan from IMF - a point that Deputy Governor Sutt repeated to DAS Garber last week as well. According to Ross, the financial standing of the Nordic banks operating in Estonia continues to be strong enough to cope with the global financial crisis and Estonia's economic contraction. "The measures taken by the governments of the Nordic countries and Estonia to further increase the credibility of banks should contribute to confidence as well," he said.

¶8. (U) In order to guarantee the safety of small depositors, deposit insurance is obligatory for banks operating in Estonia. As of October 9, 2008, 100 percent of bank deposits are guaranteed up to EUR 50,000 per depositor in a credit institution. All deposits are guaranteed, regardless of type (i.e. demand, savings, time and other deposits) and irrespective of whether the deposit is in Estonian kroons (EEK), Euros or another currency. BOE Deputy Governor Sutt pointed out to us that Estonian banks' reserve requirements are significantly higher, at 15 percent, than those of many other banks in the region (typically 3-10 percent). While the Scandinavian banks operating in Estonia have witnessed a falling-off of profits from their lucrative Baltic subsidiaries and branches, they are not in dire straits. In the third quarter of 2008, aggregate net profit in Estonia of these banks was about USD 120 million (roughly 6 percent lower year-on-year). The profit-making ability of banks has remained relatively good despite the current international financial environment and the ongoing struggles of the Estonian economy.

Current Account, Currency Peg, Ratings

¶9. (U) Judging from a range of other measures, the Estonian economy appears to be holding steady. The BOE estimates that as domestic demand falls, Estonia's current account deficit will drop to 6-7 percent in the coming years. (NOTE: Estonia's foreign trade deficit showed a 38 percent decrease in August 2008 compared to the same period a year ago. END NOTE.) In the second quarter of 2008, the inflow of the direct investments exceeded outflow by about USD 0.2 billion. So far there has been no indication of a need to devalue the Estonian kroon (EEK), which has been pegged to Euro since January 1999 at a fixed rate of 15,6466. (NOTE: Any change in the peg would require an act of Parliament. END NOTE) Lastly, in a

development our Estonian interlocutors are quick to point out, the rating agency Standard & Poor's decided in late October to leave Estonia's sovereign rating unchanged, and affirmed it as 'A' (although it did cut the long-term sovereign ratings for neighboring Latvia and Lithuania). Standard & Poor's kept its future outlook for all three Baltic countries negative. The Fitch rating agency, however, lowered Estonia's rating to 'A minus' in October. The third major agency, Moody's, last rated Estonia as 'A' in September.

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